

McGraw-Hill Economics

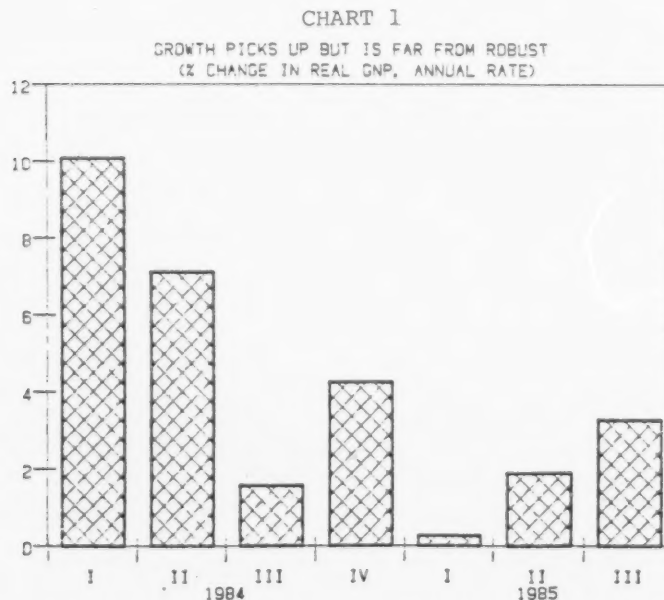
1221 Avenue of the Americas, 37th Floor
New York, New York 10020

November, 1985

Business Outlook, Short-Term

Despite the damaging fact that no major sector of the economy is strong, economic growth nonetheless manages to move along at a slow trot. In the third quarter, inflation-adjusted gross national product (GNP) rose at a 3.3% annual rate, which compares well with the previous two quarters (Chart 1), but which only lifts this year's economy 2.5% above last year's.

In the face of interest rates stuck at fairly high levels, a manufacturing sector ravaged by imports, a farm sector with silos-full of unpayable bills, bank failures, largescale layoffs at major companies, heavily indebted consumers, and a federal debt rising above \$2 trillion, 3.3% growth may not seem bad at all. But then again, faced with all those problems, how can the economy get much better?



It's clear that a hazardous course lies ahead in 1986. At best, a successful navigation means limited growth of 2-3% in 1986. A slip here and there, on the other hand, could bring serious trouble.

Gateway to Clear Sailing

If the economy in 1986 is to avoid recession and score its fourth consecutive year of growth, two things must happen: 1) housing must heat up, and 2) the dollar must fall further to spur U.S. exports. While odds are that some improvement will occur in these two markets, improvement is by no means assured. For example, on the strength of lower mortgage rates, housing starts in 1986 are forecast to reach 1.8 million, a good number by historical standards. But that forecast is subject to much downside risk. On a simplistic level of analysis, housing starts rarely increase four years in a row, as the forecast would have it.

Digging deeper, housing must overcome problems eating away at its foundation:

- * After-tax, inflation-adjusted personal income grew only sluggishly in 1985, and no improvement in growth is foreseen in 1986.
- * While overall income has grown in recent years, those at the top of the economic ladder have been garnering a greater and greater share. This two-tier income growth may limit demand for new houses by people on the middle and lower-middle rungs of the economic ladder.
- * Delinquency and foreclosure rates on mortgages are at an all-time high. In an attempt to curtail bad loans, Fannie Mae has tightened its standards for buying mortgages in the secondary market.

High and rising delinquency and foreclosure rates suggest that incomes did not rise as rapidly as people expected when they bought their houses, or that mortgage rates are still very high despite their decline of the past year, or

both. Whatever the underlying reason, these indicators of financial distress among homeowners bode no good for residential construction. One obvious point is that more foreclosures mean more houses on the market. It also suggests that if those who have already bought are having a tough time of it, many of those who have hesitated are probably in no better shape--they have merely been more cautious.

Caution may have especially gripped middle and lower-middle income people. For since the late 1970s, these Americans have seen their inflation-adjusted incomes decline. In contrast, people in the top two-fifths of income earners have enjoyed real increases in living standards. Table 1 helps to illustrate this point, showing that income of the top fifth of families rose to 42.7% of total income in 1984 from 41.5% in the late 1970s. The share of income received by those in the second and third fifths fell from 29.1% in 1978-79 to 28% in 1984. For single persons not living in families income is even more heavily concentrated at the upper end.

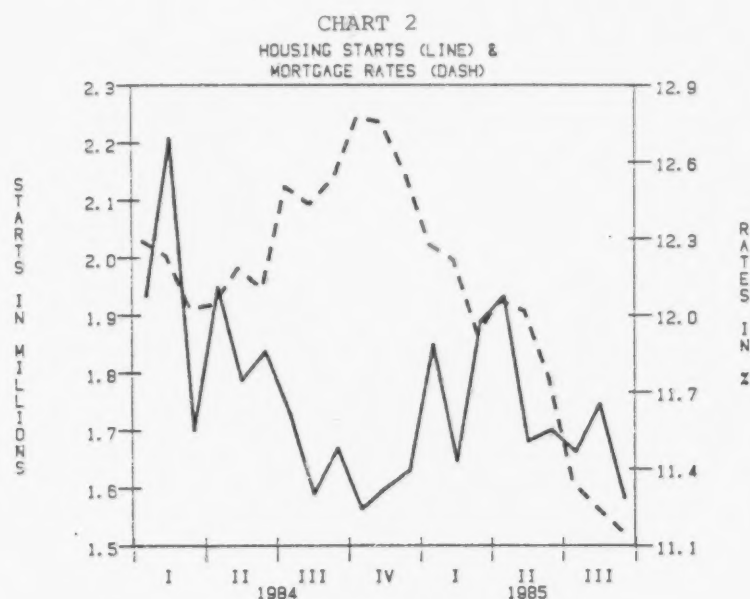
Table 1. Income Distribution of American Families

-----% of total income earned-----				
<u>Quintile</u>	<u>1978</u>	<u>1979</u>	<u>1983</u>	<u>1984</u>
Lowest fifth	5.2	5.2	4.7	4.7
Second fifth	11.6	11.6	11.1	11.0
Middle fifth	17.5	17.5	17.1	17.0
Second-highest fifth	24.1	24.1	24.4	24.4
Highest fifth	<u>41.5</u> 100%	<u>41.7</u> 100%	<u>42.7</u> 100%	<u>42.9</u> 100%

*How to read this table: The number of families was broken into five groups, and the percentage of total family income earned by each group was calculated. Each number in the table shows this percentage. So, for example, the middle group earned 17.5% of all family income in 1978 and 17.0% in 1984.

Source: U.S. Census Bureau

Given this skewing of income in recent years to higher-income people, it's possible that the pent-up demand presumed to exist in the housing market will remain pent up because it affects mostly middle income people. It is therefore possible that even further small declines in mortgage rates will not be sufficient to release the spate of new housing demand that has been expected but has not materialized this year. (Chart 2 shows that the usual stimulative effect of falling mortgage rates on housing did not work this year.) In short, one of the hopes for the 1986 economy may be on skids.



The Dollar: Down But Not Out

The other hope is that the dollar will continue its recent decline so that U.S. exports will rise next year and imports fall.

The super-strong dollar has, of course, taken a tremendous toll on U.S. manufacturing in the past half decade (Chart 3). Recently, however, the U.S. along with major trading partners announced a policy of market intervention to beat the dollar down. Hopes may thereby have been raised that the trade

picture would improve, especially when the dollar's initial response to the new policy was to drop sharply.

But after the initial drop, the dollar started to come back. While it is not expected to return to its earlier high this year, the rebound does suggest an important conclusion: The dollar will retain much of the strength it has built up since 1980. Reasons: 1) Though down considerably in the past year, interest rates in the U.S. are still high when adjusted for inflation, especially compared with Japanese rates. 2) Outside of interest rates, investment here may still look attractive since foreign investment in Japan is restricted while economic growth in Europe is very sluggish.



What's more, the government's success rate in directly controlling the exchange rate is not good. Remember the late 1970s when the Carter administration tried to boost the dollar by using foreign currency to buy dollars. The gambit didn't work. The dollar stayed down in the dumps until interest rates soared in 1980; shortly afterwards, under President Reagan, the dollar's continued strength was ensured when plummeting inflation was accompanied by growing budget deficits, resulting in sustained high real interest rates.

In other words, direct government attempts to dominate the dollar have not worked, while more general economic policies have strongly affected the exchange rate.

The prognosis, therefore, is that the latest attempt to control the dollar will not be a smashing success. Further, given still-high real interest rates, the dollar will probably not fall dramatically enough to turn the 1986 economy from wishy-washy to robust.

The Rocky Shoals

What, on the other hand, could send a wishy-washy economy down the drain is a steep sag in capital investment and/or consumer spending--either or both of which are distinct possibilities.

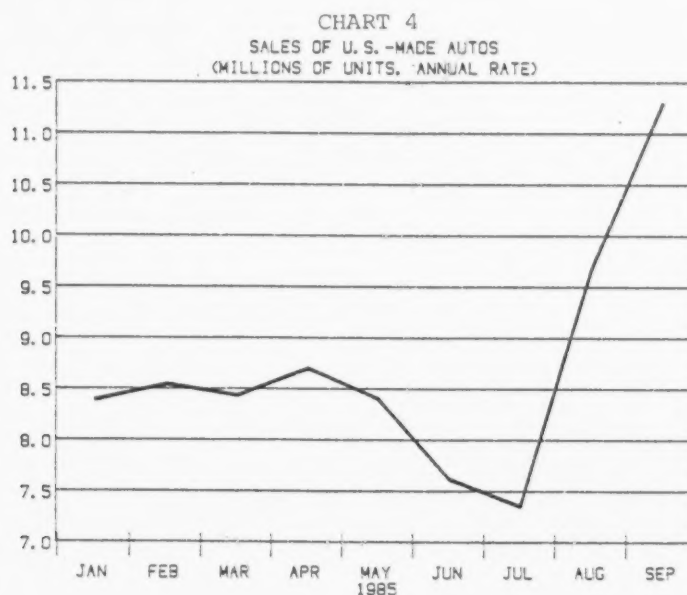
On the capital investment side, in fact, the sag has already started: In the third quarter, inflation-adjusted capital spending fell at a 4.6% annual rate.

A chief cause of this fall was a plunge in computer purchases--down 27% at an annual rate. Computer sales to business have bounced up and down this year, but on the whole have been running about the same as last year. The implication is that business' blind love for computers may be at an end. After the tremendous boom in the past few years, more and more companies are either glutted with the machines, or they are demanding more demonstrably concrete payoffs from them. In the fourth quarter, however, computer sales will probably perk up, based on a recent rise in new orders and increased shipments of IBM's new Sierra models.

Outside of computers, most other capital goods markets are also weak. The only strong equipment markets in the third quarter were in transportation--autos, railroad equipment, and aircraft. And the burst of auto sales to business, just as with consumers, presumably resulted from temporary financing incentives.

On the structures side of capital spending, things were also crumbling. Construction of almost all major types of structures fell--including factories, offices, retail and wholesale buildings, health care facilities, telephone structures, and power plants. Surprisingly, outlays for oil and gas wells rose slightly. All told, real nonresidential construction dropped 7.7% at an annual rate in the third quarter.

While both structures and equipment weakened in the third quarter, construction is probably in more trouble. If the office building boom is coming to a halt, the halt could turn into a crash. If manufacturers start thinking recession in 1986, factory construction could tumble further. And unless housing reheats, shopping center developers are going to close their doors on more spending. To be nasty, brutish, and short about it, 1986 could be a terrible year for construction. In turn, that means the economy next year could stop growing.



In contrast to capital spending, consumer spending almost never declines; but a decline in the growth rate could help weaken the economy. And such a decline could easily occur in the near future now that auto companies have stopped their financial incentive programs. Those programs brought hordes of

consumers into showrooms in August and September; and despite an overhang of large debt, many people could not pass up a good deal to borrow yet more money. The result: Sales of domestically-produced autos zoomed from a seasonally adjusted annual rate of 7.4 million in July to an incredible 11.3 million in September (Chart 4).

This self-induced boom helped third-quarter economic growth considerably--real spending on consumer durables was up more than 20% at an annual rate. The flip side is that consumer durables could tumble in the fourth quarter, pushing GNP down.

Aside from the special auto situation, consumer spending does not exactly look like a powerhouse. Personal income has been advancing only sluggishly. Employment has been doing better, but that's because most of the growth has been in relatively low-paying trade and services jobs. Meanwhile, many good-paying middle management jobs are getting axed: Witness recently announced layoffs at large companies ranging from communications and publishing to chemicals and heavy equipment.

Employment growth this year is chronicled in Table 2. Of the roughly

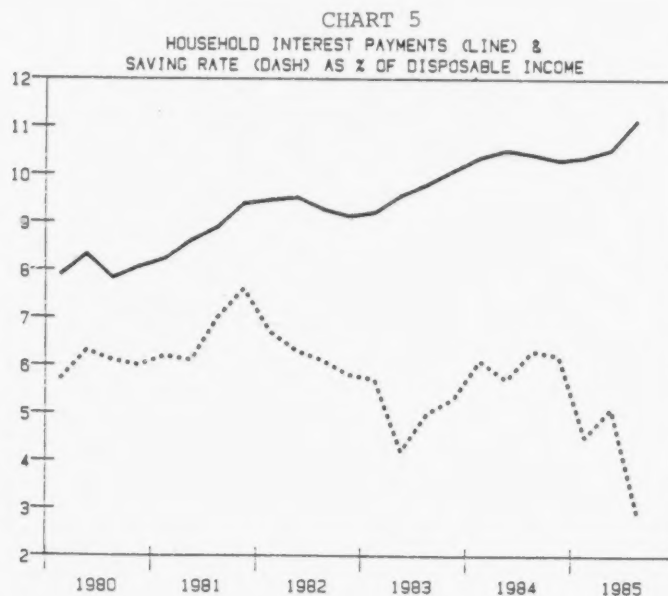
Table 2. Trade & Services Dominate Job Market in 1985

<u>Area of Employment</u>	<u>--Million Jobs--</u>		<u>% Change</u> <u>1984-85</u>
	<u>1984</u>	<u>1985(e)</u>	
Trade & Services	42.9	45.1	5.1%
Manufacturing	19.4	19.4	0.0
Finance, Insurance, Real Estate	5.7	5.9	3.5
Construction	4.3	4.6	7.0
All Other	22.2	22.6	1.8
Total Non-Farm Employment	94.5	97.6	3.3
Total Excluding Trade & Services	51.6	52.5	1.7

e-estimated

three million new jobs created in 1985, two-thirds came in trade and services, while another tenth came in what until lately had been a hot construction market. A quarter million jobs opened in finance, insurance, and real estate. In contrast, no new jobs were added in manufacturing and mining.

Decent (though not spectacular) employment growth has therefore not translated into very good income growth. Compounding, or perhaps reflecting, the consumer's problem is a heavy debt load and a low saving rate (Chart 5). Whenever consumers start trying to save more and pay off some debt, spending could slow sharply. Which in turn points to sluggish economic growth in general.



A Quarter of Special Effects

While slower growth may be ahead, the third quarter score of 3.3% was not bad. But as already noted, auto sales drove much of the growth, adding about two percentage points. Auto sales should shift into reverse in the fourth quarter as the cut-rate financing ends.

In addition to this special auto effect, the third quarter also benefited

from a huge increase in defense spending that added a percentage point to real GNP growth. While military spending is volatile from quarter to quarter, the third-quarter leap was atypical, possibly linked to the end of the federal government's fiscal year. Following this large gain, it would not be surprising if defense spending grows little or even declines in the final quarter of 1985.

So two unusual bulges--autos and defense--accounted for most of the economic growth from July to September. Reversals in these sectors could produce very poor growth in coming months.

In contrast, computers had a bad quarter and should rebound in the October-December period. An auto bust accompanied by no growth in military outlays, however, would outweigh any conceivable computer pickup. The fourth quarter, therefore, does not look promising.

Summary

Trying to find pockets of strength in the U.S. economy is getting more difficult. True, the third quarter found car sales in 'high gear, but that that was only people taking advantage of deals that won't be sustained. Defense spending was powerful, too; but defense will be winding down somewhat next year, and the tremendous third-quarter burst was probably an anomaly.

Finding weakness, on the other hand, is easy. Capital spending declined, and the fundamentals point to no great resurgence: Corporate profits are about flat; operating rates are low; and sales are struggling. Housing, despite mortgage rate declines, is in trouble, suggesting that something fundamental is wrong. The something fundamental could simply be that people who would like to buy houses don't have the money, at least not enough money given that mortgage rates are still 11%-12%.

One reason American consumers may not have the money is that they are spending over their heads, as attested to by their large debt burdens. Another indicator of how deep consumers are digging into their pockets is that the saving rate in the third quarter hit an incredibly low 3% of disposable income.

One hope for 1986 is that the dollar continues to decline in an orderly way, spurring exports and pricing some imports into a smaller share of the U.S. market.

For the moment, the forecast looks for enough of a housing and foreign trade turnaround to avert a downturn in 1986. But housing and trade are thin reeds on which to raise an edifice of economic growth.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

	1985				1986				1987	Years		
	III	IV	I	II	III	IV	I	II	I	84	85	86
National Product Accounts												
Gross National Product.....	3,916	3,972	4,012	4,051	4,105	4,172	4,256	3,663	3,888	4,085		
Consumer Spending.....	2,537	2,554	2,585	2,616	2,650	2,686	2,735	2,342	2,508	2,634		
Durables.....	356	340	340	342	345	349	356	319	342	344		
Nondurables.....	896	903	910	917	924	933	945	857	892	921		
Services.....	1,285	1,311	1,334	1,356	1,381	1,405	1,434	1,166	1,273	1,369		
Nonresidential Fixed Investment.	468	466	467	470	475	481	492	426	463	473		
Structures.....	167	169	169	168	168	167	170	150	167	168		
Equipment.....	301	297	298	302	308	313	322	275	296	305		
Inventory Change.....	-8	35	32	22	22	24	23	58	21	25		
Residential Investment.....	159	158	161	164	168	172	177	150	155	166		
Federal Government.....	347	342	333	334	336	340	348	295	333	336		
Defense.....	253	250	254	257	261	265	272	222	244	259		
Nondefense.....	94	92	80	77	75	75	76	74	89	77		
State & Local Government.....	499	507	515	523	530	537	545	452	491	526		
Net Exports.....	-89	-94	-85	-82	-80	-73	-70	-64	-88	-80		
Real GNP (1972 Dollars).....	1,685	1,693	1,697	1,702	1,714	1,727	1,746	1,639	1,678	1,710		
(% change, annual rate).....	3.3	2.0	0.9	1.3	2.7	3.2	4.4	6.8	2.4	1.9		
Implicit Price Deflator.....	2,324	2,346	2,364	2,380	2,396	2,416	2,438	2,234	2,317	2,389		
(% change, annual rate).....	3.3	3.8	3.1	2.6	2.7	3.4	3.7	3.8	3.7	3.1		
Key Economic Indicators												
Housing Starts (million units)...	1,664	1,786	1,760	1,797	1,850	1,899	1,903	1,766	1,754	1,827		
Retail Auto Sales (million units)	12.5	10.5	10.4	10.4	10.4	10.4	10.5	10.4	11.2	10.4		
Industrial Production	166.8	167.1	167.4	167.5	168.6	169.9	172.1	163.1	166.5	168.4		
(Index, 1967=100).....	7.1	7.2	7.3	7.4	7.5	7.6	7.5	7.5	7.2	7.4		
Civilian Unemployment Rate.....												
Consumer Price Index	2.4	2.7	3.4	3.6	3.0	3.7	3.8	4.3	3.4	3.2		
(% Change, Annual Rate).....	3,199	3,250	3,294	3,341	3,392	3,444	3,512	3,012	3,192	3,368		
Personal Income (billion \$).....	7.1	7.2	7.2	6.8	6.9	7.0	7.3	9.5	7.5	7.0		
3-Month Treasury Bill Rate (%)...	11.0	11.0	10.8	10.6	10.4	10.3	10.2	12.7	11.5	10.5		
Corporate Bond Yield (%).....												
Personal Income	3,199	3,250	3,294	3,341	3,392	3,444	3,512	3,012	3,192	3,368		
(\$ Billions, SAAR).....												

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BUSINESS OUTLOOK, SHORT-TERM

The air is full of bullishness. For in December, all kinds of good economic statistics emanated from Washington: retail sales shot up 1.9%, housing starts surged 17.5%, industrial production rose 0.7%, employment grew by several hundred thousand, and new orders for nondefense capital goods skyrocketed 13.7%.

Besides the lagged monthly numbers, day-to-day market numbers have also been bringing good news of late: the stock market maintains its vigor, the dollar trends down, and oil prices plunge. The oil price plunge, in particular, contains big implications for American business--and most of the implications are good.

In line with this mood, the upbeat Reagan administration foresees 4% growth for the economy in 1986. And indeed, as suggested above, everything suddenly seems to be going right. Yet despite a patina of euphoria surrounding the economic outlook, most private forecasters are more doleful than the government, which may be swayed in its forecasting by the fact that higher growth projections produce smaller deficits, on paper.

The consensus economic forecast for 1986 calls for around 3% growth, similar to last year's consensus for 1985. Last year's consensus turned out a little too optimistic--the 1985 economy grew only 2.3%. And despite the recent good news, a near rerun is expected in 1986. Inflation-adjusted gross national product is forecast to rise 2.4%, with no major sector of the economy strong enough to make 1986 a banner year. In particular, consumer and

capital spending are expected to be sluggish.

One of the brighter spots this year should be housing, on the assumption that mortgage rates will continue to decline. Also, after a long drought, U.S. exports should start to do better in the wake of the falling dollar, which should also quell the growth rate of imports.

This improvement in the trade balance, however, follows on the heels of record red ink in 1985. What's more, December's spate of glowing economic statistics could in reality be something of a snow job, glistening brightly only in contrast to tarnished numbers earlier in the year. Underneath the glitter, prospects for the 1986 economy are distinctly mundane.

What About All Those Great Numbers?

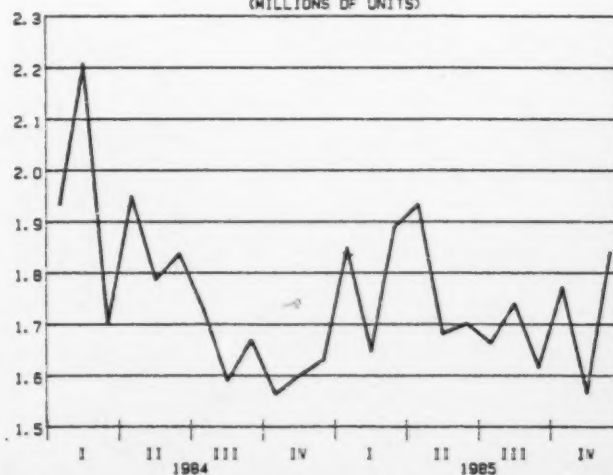
Financial markets have gone agog of late as one rosy economic statistic after another has sailed forth from Washington. But while the most recent data are certainly bullish, they should not be read out of context.

Retail sales, for example, surged 1.9% in December (Chart 1). Undeniably, that's good news, especially considering that consumers heavily laden with debt are a potential sore spot for 1986. But, as has been the story so often

CHART 1
RETAIL SALES
(BILLIONS OF \$)



CHART 2
HOUSING STARTS
(MILLIONS OF UNITS)

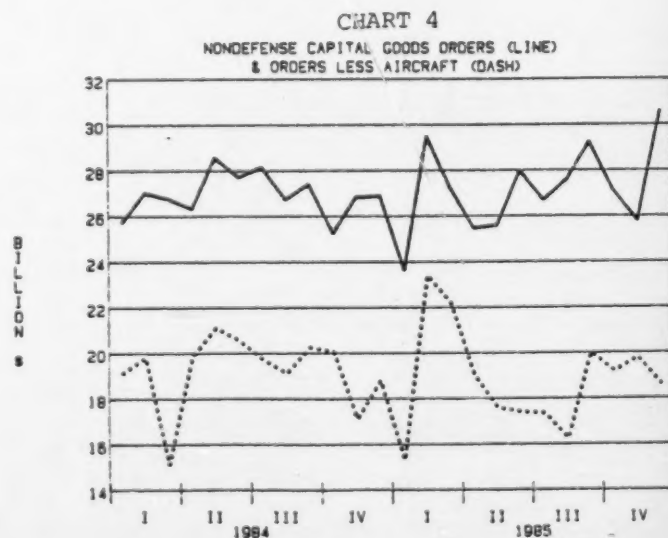
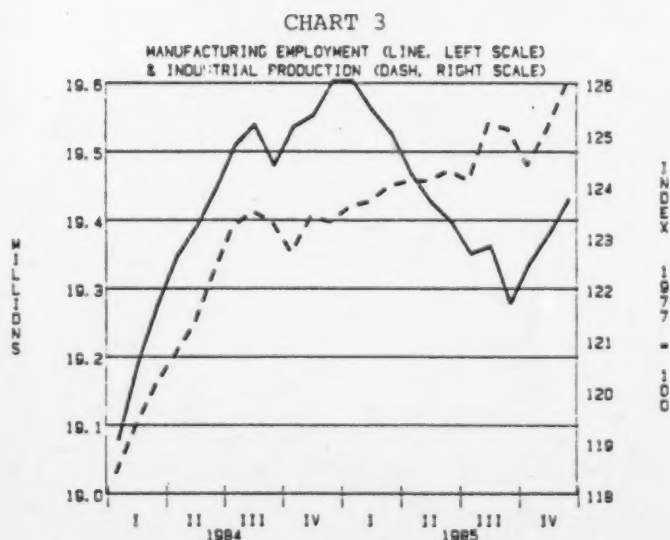


of late, much of this surge came from another boost in car sales fueled by financing incentives on selected models. Taking a broader view, retail sales in the entire fourth quarter actually fell a little from the third quarter, when the auto deals were introduced and when they covered more models.

More impressive than the December jump in retail sales was the 17.5% explosion of housing starts (Chart 2). Again, this is undeniably good news. But consider that in November housing starts plummeted 12%, and that December brought the yearly total to only 1.741 million, 1.4% below 1984's level, despite lower mortgage rates.

Yuletide joy was also generated in the long-dormant manufacturing sector. December marked the third consecutive monthly rise in manufacturing employment (and January marked the fourth), while industrial production jumped and new orders for nondefense capital goods skyrocketed 13.7% (Charts 3 and 4). But excluding aircraft, new orders dropped in December; and even including aircraft, new orders for 1985 as a whole only about equaled 1984's level. (Aircraft orders include both military and nonmilitary.)

True, the trend in production and manufacturing employment is encouraging;

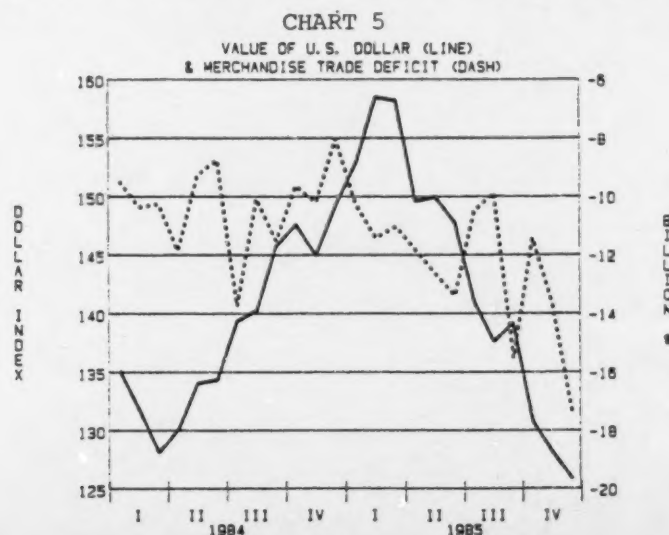


yet production in 1985 as a whole edged up only about 2% and manufacturing workers on the job in December numbered 183,000 fewer than a year earlier. The good news here is that higher production with fewer people means manufacturers boosted productivity last year.

Back to the Real World

While December's economic data look inspiring, then, closer examination reveals that they hardly auger a spirited pickup in economic activity in 1986. On the contrary, deepseated problems remain: the trade deficit remains mammoth, siphoning off output and employment from American factories; the federal deficit remains mammoth, siphoning off savings and thus making interest rates higher than need be; the dollar remains strong, even after its recent dramatic decline, keeping up the pressure on exporters and competitors against imports; and interest rates adjusted for inflation remain high, cutting off demand for perhaps two or three hundred thousand housing units. To be sure, these problems are becoming less problematical; yet they are still irksome enough to keep economic growth restrained this year.

Take the merchandise trade deficit. In 1985 as a whole, the deficit hit a record \$148.5 billion; and in December alone, it surged to \$17.4 billion... despite the plunge in the dollar (Chart 5). The point highlighted by Chart 5



is that a declining dollar does not mean an immediate jump in exports and a drop in imports. The implication: The trade balance will continue to be a thorn in the side of the economy.

This is true in part because so much of our trade now is with East Asian countries whose currencies are pegged to the dollar. In 1985, some 18% of all U.S. manufactured imports came from East Asian countries such as Korea, Taiwan, Singapore, and Hong Kong (Table 1). Of the largest bilateral trade deficits in 1985, one was with Taiwan (\$13.1 billion), another with Hong Kong (\$6.2) billion, and a third with Korea (\$4.8 billion). Another 28% of manufactured imports came from Japan, whose soaring yen has hardly shut down that country's sterling export performance.

----- Table 1. U.S. Imports by World Region -----

% From:	<u>Total Imports</u>	<u>Manufactured Imports</u>
Japan	19.9%	28.3%
East Asia	14.7	18.3
Western Europe	22.7	24.0
Excl. UK	18.4	20.3
Canada	20.2	18.7
Latin America	12.5	6.1
Other	10.0	4.6
	<u>100.0%</u>	<u>100.0%</u>

With the dollar down considerably in recent months against Western European currencies, excepting the British pound, the U.S. trade balance should certainly improve this year. Yet note in Table 1 that Western Europe excluding the UK accounted for not much more import market share than did the East Asian countries. Also note that Canada is a big player in U.S. import trade, and the Canadian dollar has been very weak against its U.S. counterpart (Table 2), having fallen some 6% during 1985 and more than 15% from its 1980

average. So the dollar decline, which should help U.S. companies compete against the continental Europeans, may not be a big help against other regions of the world. What's more, note in Table 2 that by and large the U.S. dollar in January 1986 was much stronger against most other currencies than in 1980, the big exception being the yen.

The conclusion on trade in 1986: For a change, it will help the U.S., but not by enough to impart true vigor to the rest of the economy.

Table 2. Exchange Rates

<u>US\$/Currency</u>	----Annual Average----			Jan.	Jan.
	<u>1980</u>	<u>1984</u>	<u>1985</u>	<u>1985</u>	<u>1986</u>
Canada	.855	.772	.732	.755	.711
United Kingdom	2.32	1.34	1.30	1.13	1.42
<u>Currency/US\$</u>					
France	4.22	8.74	8.99	9.70	7.48
Germany	1.82	2.85	2.94	3.17	2.44
Japan	227	238	238	254	200
<u>Trade-Weighted Dollar Index</u>					
Index, 1973=100	87.4	138.3	143.2	152.8	123.7

Interest Rates Could Fall, but They're Still High

Now take interest rates. In the past year, as economic growth slowed, business loan demand cooled off, which combined with strong money supply growth to push interest rates down significantly (Chart 6). Meanwhile, the inflation rate stayed pretty much in the 3%-4% range, meaning that "real"

CHART 6

INTEREST RATES ON COMMERCIAL PAPER (LINE)
& CORPORATE BONDS (DASH)

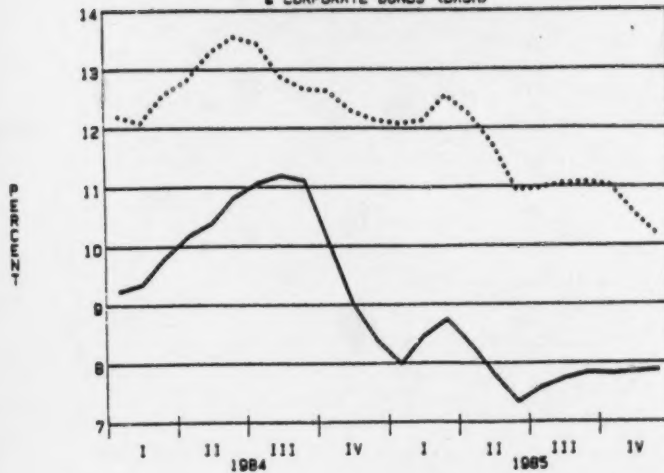
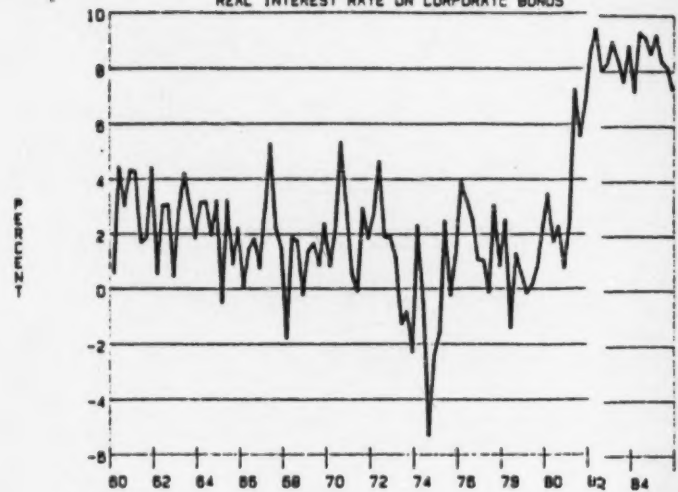


CHART 7

REAL INTEREST RATE ON CORPORATE BONDS



interest rates have also come down in the past year.

Yet in 1985, housing starts fell below their level of 1984; and the only way that auto companies could get sales unstalled was to lower the interest rate they charged on loans. In other words, in many people's eyes, interest rates are still out of sight. And these people aren't wrong, as shown in Chart 7, which tracks inflation-adjusted interest rates by quarter during the past quarter century. Today's rates, while among the lowest in five years, are still high compared to the 1960s and 1970s. As a result, rates will continue to exert a restraining influence on the economy.

Continued modest growth, however, will ensure that interest rates stay down. Which implies that rates will not sink the economy in 1986. Especially important in preventing a rate rise, and possibly in giving rates a further nudge down, should be falling inflationary expectations, thanks to the recent plunge in world oil prices. With U.S. wages growing only about 3% per year, with Gramm-Rudman forcing Congress to cut the federal deficit, with inflation in the 4% range for the past three years, with farm and industrial prices weak, and now with crude oil prices tumbling, it's hard to see how

inflationary expectations will be playing a major role in interest rates.

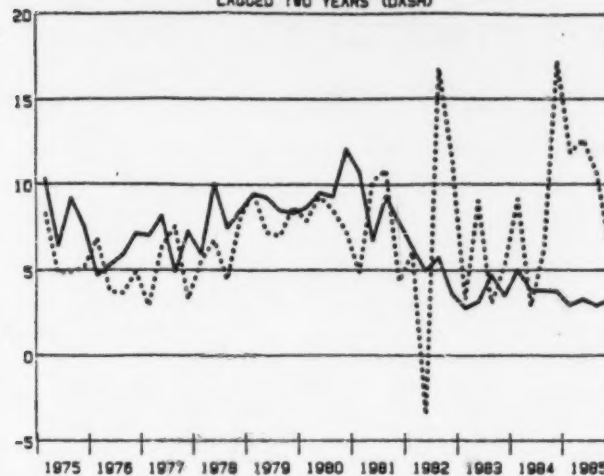
Perhaps the only important force currently working to boost inflation is the declining dollar, which will make imports and import-competing domestic products more expensive. Already, for example, Japanese producers have raised prices on certain consumer items, such as autos. But in other areas, where foreign producers are under more competitive pressure, the story may be different: Foreign producers may decide to trim (sometimes fat) profit margins and keep prices down in order to retain market shares won in the past five years when the dollar soared. And as noted earlier, some Asian countries won't have to worry about the declining dollar because their currencies are hitched to the buck. All in all, then, inflation should remain under wraps through 1986 and into 1987.

In turn, low inflation implies that investors should build less of an inflation premium into the return that they demand. This ratcheting down of inflationary expectations could be one reason for 1985's fall in interest rates at the same time that inflation itself has been fairly constant.

The reason that real interest rates (around 7%-8% today on high-grade corporate bonds) have not fallen back to historically normal levels of less than 2% is probably linked to the federal budget deficit. With deficits sticking in the \$200 billion range, some people feel the government will eventually have to reflate the economy by pumping out huge quantities of money. In fact, a huge amount of money has already been pumped out, yet inflation has remained well behaved, as shown in Chart 8. (Chart 8, which plots quarterly data at annualized rates of change, shows that the relationship between money and prices was quite tight until recently.) The argument that links the deficit to inflation and thus to higher interest rates does not appear to hold up.

But the deficit still exerts upward pressure on interest rates by the fact

CHART 8
INFLATION (LINE) AND % CHANGE IN MONEY SUPPLY
LAGGED TWO YEARS (DASH)



that the government is a continual, massive presence in the financial markets, constantly keeping up the demand for funds. So in basic supply and demand terms, government borrowing is keeping interest rates higher than they would otherwise be.

Consumer and Business Spending Look Unexciting

It's true that the government is currently acting to reduce the deficit. Both Gramm-Rudman and the President's proposed fiscal 1987 budget reduce the deficit by some \$60 billion from recent years. And financial markets did welcome this prospect by bidding bond prices up.

But will the government deliver? In particular, if economic growth does not hit the administration's 4% target, tax revenue will fall short of projections while safety net expenditures will come in higher.

One big reason this could happen is that consumer spending may have run out of steam, cooled off by huge debt loads and small savings. Some recent evidence: Large department store chains reported sluggish sales in January.

Business investment in new plant and equipment, a powerhouse earlier in

this economic expansion, may also have run out of steam. According to the McGraw-Hill and U.S. Commerce Department surveys, companies plan to cut inflation-adjusted investment in 1986. Granted, an upsurge in the economy early in the year would cause firms to upgrade their investment plans, but they are apparently starting from a low base. If tax reform in Congress appears to include elimination of the investment tax credit in 1987, some companies could try to bunch their plant and equipment purchases into 1986. But the fundamentals of modest economic growth in 1985 and 1986, slow profits growth in 1985, and the big stocking up of buildings and equipment in recent years, points to lackluster investment in 1986.

Summary

The economic outlook has distinctly improved of late. Employment is growing quickly; housing and retail sales have rebounded; and industrial production has been picking up. This barrage of good news has convinced many forecasters that 1986 will be a very good year.

The view here is more restrained. For one thing, this recent spate of economic statistics looks good primarily in contrast to a year of not very good (though not bad, either) numbers. For another, serious problems remain, such as the trade deficit and high real interest rates. True, the sinking dollar will help American companies in world markets this year; but the trade deficit will remain large, in part because significant competition comes from Asian countries whose currencies are tied to the dollar.

Near-record real interest rates will also inhibit economic growth. At the same time, market interest rates could well decline further this year as the government works to cut the deficit, and as falling oil prices feed into lower inflationary expectations. Because of such offsets to the economy's problems, the business expansion that started in 1983 is expected to proceed through another year.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS

(Billions of Dollars, SAAR)

	1986				1987				Years		
	1985	I	II	III	IV	I	II	84	85	86	
National Product Accounts											
Gross National Product.....	4,075	4,140	4,186	4,245	4,293	4,358	4,438	3,775	3,993	4,216	
Consumer Spending.....	2,633	2,682	2,713	2,747	2,781	2,826	2,873	2,423	2,582	2,731	
Durables.....	359	371	374	377	378	383	392	331	361	375	
Nondurables.....	929	938	942	949	956	968	976	872	912	946	
Services.....	1,345	1,373	1,397	1,421	1,447	1,475	1,505	1,220	1,309	1,409	
Nonresidential Fixed Investment.	491	488	490	495	493	492	498	428	476	492	
Structures.....	174	177	179	183	183	186	188	148	170	181	
Equipment.....	317	311	311	312	310	306	310	280	306	311	
Inventory Change.....	2	22	30	29	30	24	29	67	9	28	
Residential Investment.....	188	191	197	205	211	216	221	175	181	201	
Federal Government.....	379	359	347	351	346	352	356	313	354	351	
Defense.....	273	267	263	267	270	276	280	237	262	267	
Nondefense.....	106	92	84	84	77	76	76	76	92	84	
State & Local Government.....	475	483	491	497	504	511	517	424	461	494	
Net Exports.....	-97	-91	-87	-85	-78	-68	-61	-59	-74	-85	
Real GNP (1982 Dollars).....	3,605	3,629	3,646	3,672	3,686	3,709	3,747	3,492	3,574	3,658	
(% change, annual rate).....	2.4	2.7	1.8	2.9	1.5	2.5	4.2	6.6	2.3	2.4	
Implicit Price Deflator.....	2.296	2.316	2.330	2.346	2.363	2.384	2.400	2.217	2.278	2.339	
(% change, annual rate).....	2.4	3.4	2.5	2.7	3.0	3.6	2.6	3.2	2.8	2.7	
Key Economic Indicators											
Housing Starts (million units)...	1.726	1.770	1.884	1.953	1.990	2.008	1.987	1.766	1.741	1.899	
Retail Auto Sales (million units)	10.3	10.8	10.5	10.7	10.6	10.7	11.0	10.4	11.1	10.6	
Industrial Production											
(Index, 1967=100).....	167.6	169.4	169.6	170.7	172.2	173.3	176.1	163.1	166.7	170.5	
Civilian Unemployment Rate.....	7.0	6.9	6.9	6.8	6.9	6.9	6.9	7.5	7.2	6.9	
Consumer Price Index											
(% Change, Annual Rate).....	4.1	3.1	2.6	3.4	3.6	3.7	2.9	4.3	3.5	3.2	
Personal Income (billion \$).....	3,357	3,414	3,457	3,505	3,549	3,598	3,657	3,112	3,294	3,481	
3-Month Treasury Bill Rate (%)...	7.2	7.0	6.9	6.7	6.5	6.4	6.3	9.5	7.5	6.8	
Corporate Bond Yield (%).....	10.6	10.0	10.1	9.7	9.5	9.3	9.2	12.7	11.4	9.8	
Personal Income											
(\$ Billions, SAAR).....	3,357	3,414	3,457	3,505	3,549	3,598	3,657	3,112	3,294	3,481	

NOTE: GNP data were revised in late December; constant-dollar data are now based to 1982.

McGraw-Hill Economics

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New York, New York 10020

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Business Outlook, Short-Term

The euphoria is fading.

Just a few months ago, rapid economic growth was the byword of many economic forecasters. And for good reason: Interest rates, oil prices, and the dollar were all plummeting.

Yet despite all this good news the economy in 1985's fourth quarter grew barely at all. The unemployment rate shot up from 6.6% in January to 7.1% in March. And industrial production has sagged. True, first-quarter 1986 growth improved to a 3.2% annual rate; but most of the growth came from inventory accumulation, which may reflect slack sales. Excluding inventories, the economy in January-March shrank 0.4% annualized.

What the rose-colored glasses set failed to see, apparently, were the economy's negatives: heavily indebted consumers facing slow wage growth, companies cautious about capital spending, a stubborn trade deficit that will improve only slowly. Lower interest rates, too, may be a mixed signal--interest rates often fall when the economy is weakening and loan demand drops. So far, only housing has responded to the decline in rates, and housing's ripple effect on other industries has not yet done much for overall economic growth.

Besides being off target on the big economic sectors such as consumer and business capital spending, the optimists underestimated the impact of plunging oil prices on the oil patch. The recent spurt in the unemployment rate, for example, stems partly from oilfield layoffs. And slashed



exploration and production budgets are cutting into U.S. investment.

Eventually, the forces focused on by the optimists will certainly stimulate the economy. Lower oil prices are putting billions into the pockets of businesses and consumers at the same time that lower interest rates are easing their debt burdens. Meanwhile, U.S. competitiveness in the international marketplace is increasing against the Europeans and Japan. It's a matter of timing: The oil patch is getting hurt deeply and immediately; the rest of the economy is benefiting mildly and slowly. On trade, Americans are paying higher prices for imports, leading to record merchandise trade deficits; but eventually, higher import prices will cause some switching to American-made products.

When the adjustments are made, the economy should look better--in 1987. For the time being, growth in 1986 looks to be sluggish.

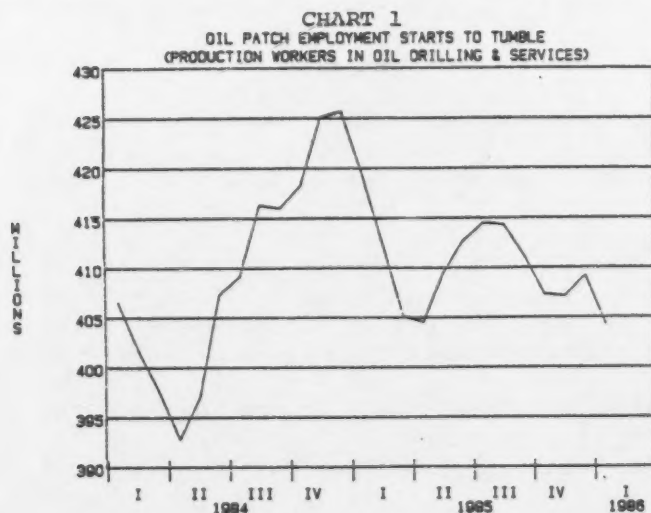
Lower Oil Prices: The Benefits Take Time to Flow

That famous tumbling act featuring interest rates, the dollar, and oil prices is affecting all businesses and consumers, one way or the other. Of that trio, the tumbling dollar probably has the least immediate effect on most people. Tumbling interest rates have a broad effect on business; but unless you're buying a house you may not notice the tumble too much as a consumer. For example, rates that consumers face on credit cards and car loans are not much changed.

The biggest immediate effect, then, probably comes from falling oil prices. For both businesses and consumers, gasoline and heating oil prices have plunged. Hence cash flow is up. Considering that the U.S. imports roughly three million barrels of oil per day, the roughly \$15/barrel plunge in the price of oil since November saves Americans about \$18 billion per year.

But while Americans in general benefit, the oil industry has been axing capital budgets and laying off workers, the immediate impact of which will help offset some of the good things stemming from the oil price decline. Consider this: In 1985, oil companies spent some \$33 billion on oil and gas exploration and production. If these expenditures get slashed by a third, it would offset more than half of the \$18 billion in savings from cheaper imported oil. Workers, too, are feeling the brunt. In February alone, oil service companies cut employment 7%. Drilling companies pared payrolls by only 1%, but more layoffs are inevitable.

Oil patch layoffs in February totaled 21,000 (Chart 1). With further layoffs, wage and salary losses could run into a couple of billion dollars. All of which is not to cry crocodile tears for an industry that did very nicely during OPEC's ascendancy; but it does point out that the hurt of lower oil prices is immediate and dramatic. The good effects flowing from cheaper oil will take time getting through the pipeline. Right now, even the savings from lower-priced gasoline and heating oil may not spur consumers to open their wallets wide.



The Constrained Consumer

What with all the economic news going the consumer's way lately, you'd think consumer spending would be booming. For not only are interest rates and oil prices down, the stock market is up...way up. People should be feeling richer, and thus in a big spending mood.

But the latest statistics belie the good news. Retail sales in March were no higher than in December (Chart 2). Lacking special financing incentives, domestic auto sales plunged in March (Chart 3). Overall consumer spending in the first quarter did rebound to a 4.3% annualized growth rate after inflation, compared with no growth in the fourth quarter of 1985; but spending was less than 2% higher than a year earlier.

CHART 2

RETAIL SALES SLOW DOWN

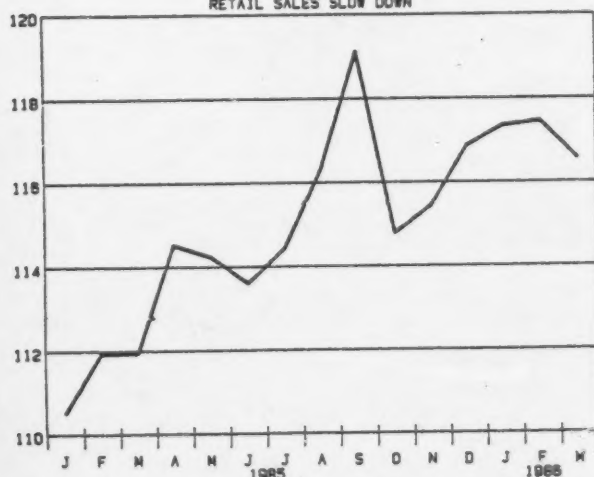
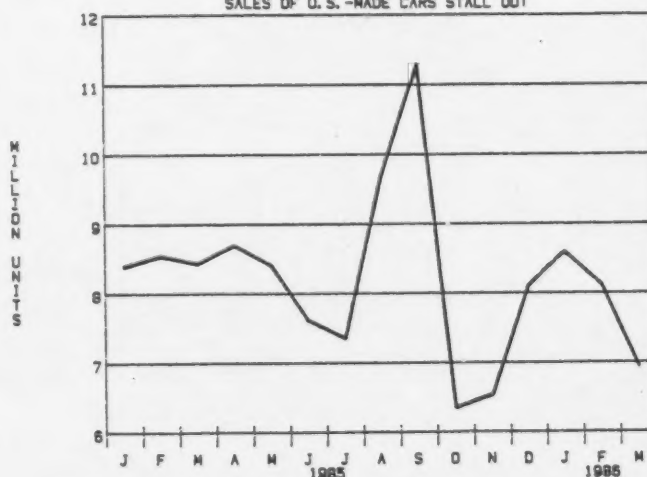


CHART 3

SALES OF U.S.-MADE CARS STALL OUT

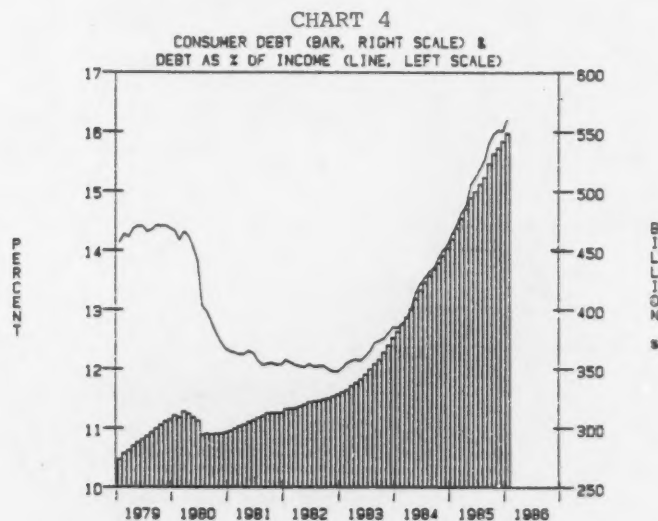


Have consumers become irrational? Don't they read the newspapers, or at least the headlines, trumpeting falling interest rates and oil prices?

They may in fact read the headlines, but if they think about borrowing on their credit card they're likely to find rates unchanged. More important, when their boss tells them about a raise, they're likely to find that it's only about 3%. And if they read the headlines about the bull rampaging

through Wall Street, all that action is likely to seem very remote, since most people's connection with the stock market is through their pension fund.

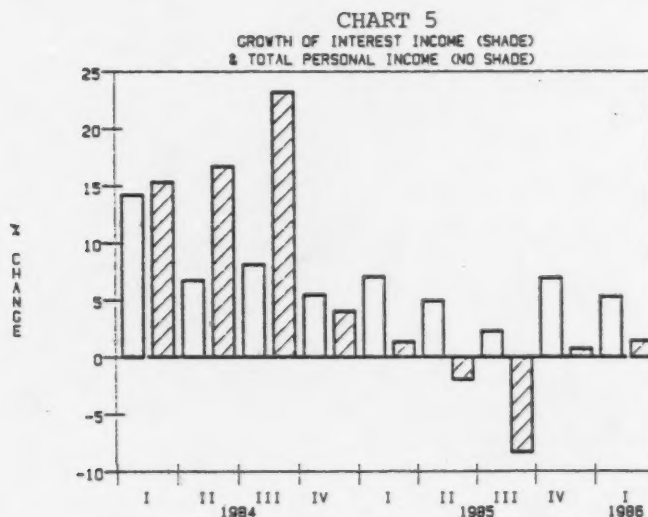
What's more, this subdued consumer attitude may prevail for some time. Key reason: The record debt burden the consumer is now carrying (Chart 4). At some point, that burden will be brought back down to historically normal levels. It probably can't be brought down by rapid income growth. The alternative then is for consumers to cut their penchant for debt, a penchant that has caused consumer installment credit to surge 20% in the past year. Any cutback in credit would translate into slow growth in consumer spending.



Data as of January provide a small bit of evidence to suggest a curbing in consumer credit demand: In the three months ended in January, credit grew 1% a month on average, compared with 1.7% in the three months ended in October. Consumers have also modestly raised their saving rate, from 3.5% in September to 4.2% in January--still a very low rate by historical standards. Any further increase back to more normal levels would also crimp consumer spending.

Ironically, another crimp this year will be lower interest rates. As Chart 5 shows, interest earnings of consumers grew very rapidly in 1984-1985,

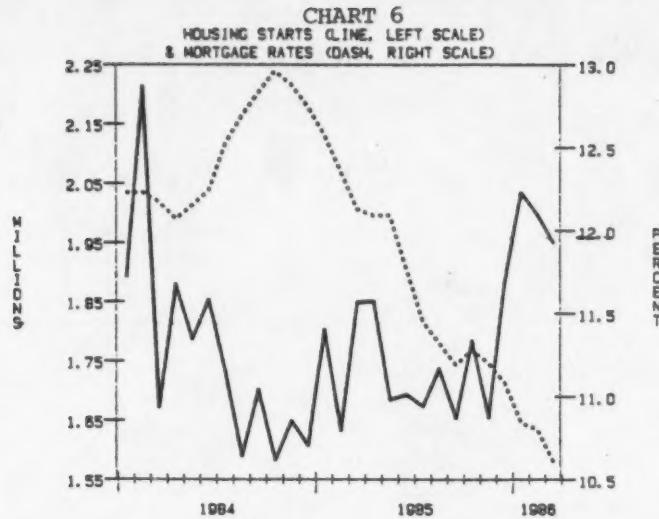
helping to fuel overall income growth. Now the tables have turned and incomes will have to grow primarily on the strength of wages, which will not be increasing very much.



Housing Hits the Fast Lane

While falling interest rates are a two-edged sword for consumer spending, they are an unadulterated blessing for the housing market. The lowest mortgage rates since 1979 have lit a fire under a distinctly cool housing market in 1985, when starts dipped 1.2%. Starts dipped last year, that is, even though mortgage rates fell. The difference between then and now is that mortgage rates have neared the single-digit range (Chart 6), making it possible for the first time in seven years for a family with median income to afford a median-priced single-family house.

According to the National Association of Realtors, the median price of a home rose less than 5% in the past year; median family income grew only a bit more, but thanks to a 1.5 percentage point drop in mortgage rates, the income needed to qualify for a mortgage fell nearly 7%.



Housing is not without its problems, however. Heavy debt burdens and sluggish wage growth coupled with falling home prices in some parts of the country have resulted in a continued high level of delinquency rates and defaults. Nationally, the percent of mortgage loans in the foreclosure process is the highest on record, according to Mortgage Bankers Association data that go back to 1961. On the brighter side, the number of foreclosures started in 1985's fourth quarter was at a normal level, though high when compared with the economic expansion lasting from 1976 to 1980.

Pockets of distress show up clearly in these data: While foreclosure proceedings were started on 0.22% of loans nationally in 1985's fourth quarter, the rate was nearly double this average in Texas and nearly triple in Oklahoma. Since these data were collected, a greater percentage of people in energy-producing states have presumably walked away from their mortgages.

In the farm belt, Iowa has a foreclosure rate double the national average, while troubled mining and energy industries have led to high rates of foreclosures in Wyoming, Nevada, and North Dakota.

With major U.S. industries in trouble, regional housing slumps are likely

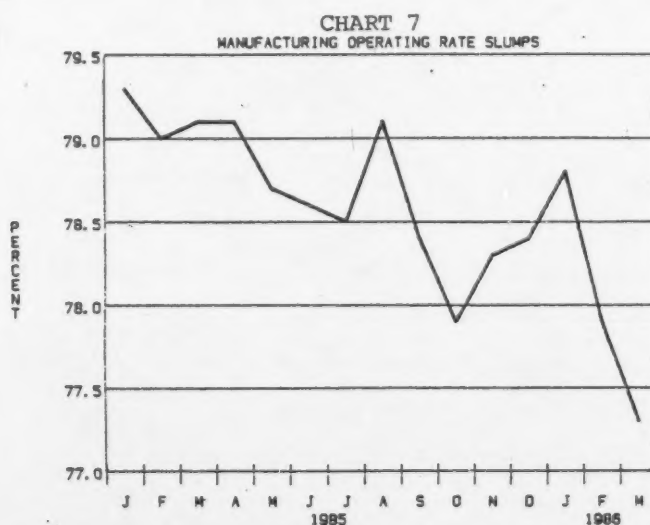
to keep overall housing starts from attaining boom proportions this year (significantly over two million), despite the great news on mortgage rates and affordability. But further good news on these fronts will keep housing hot.

Capital Spending Crumbles

Not so hot will be capital spending in 1986, as evidenced by 1986's first quarter: After inflation, investment plunged at a 13.6% annual rate.

One reason is petroleum. Real oil and gas well drilling, part of the structures figure that goes into nonresidential fixed investment, plunged at a 39% annual rate in the first quarter. With petroleum structures comprising 8.5% of total real investment, the slide in this sector makes a distinct mark on total investment. And with oil prices half what they were a half year ago, it will continue to make a mark.

Investment in the first quarter was also dragged down by a huge cut in computer purchases. Computer investment is expected to pick up from its currently depressed level, but the year as a whole will still be weak. Another reason to expect lackluster investment performance this year is manufacturing's low and slumping factory operating rate (Chart 7).

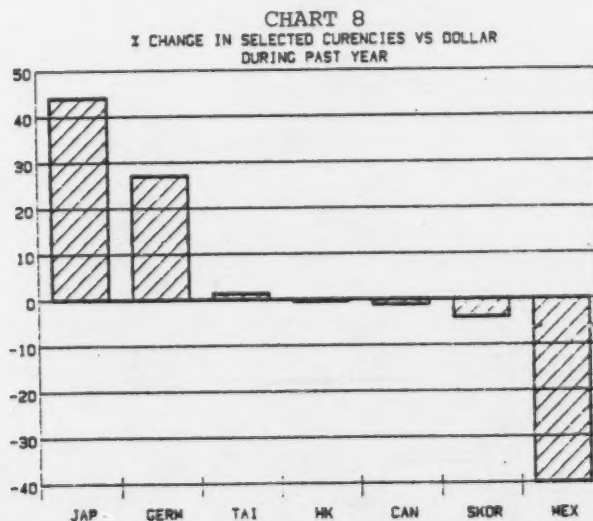


Yet another reason to expect weak investment this year is last year's corporate profits decline and sluggish sales growth. Thus far in 1986 sales and profits do not appear stellar, the boom on Wall Street notwithstanding. Rising stock prices, however, will not boost capital investment. Rising business sales and profits will; so until the latter happens, outlays for new plant and equipment will be held in check.

Foreign Trade Still a Struggle

Another major sector of the economy that may disappoint this year is foreign trade. Despite the marked drop in the dollar through 1985, U.S. merchandise trade deficits continued to deepen; for the year as a whole, the deficit set a record. More recently, the deficit has improved, thanks to lower oil prices, not the lower dollar.

For manufacturers, 1986 could be another rough year in the international arena. True, the Japanese yen has skyrocketed in the past year, and the German mark has risen considerably. But as shown in Chart 8, the currencies of other important trade partners have either held steady or declined against the U.S. dollar.



Since East Asian nations have become important exporters of manufactured goods to the U.S., the fact that their currencies are tied to the dollar does not bode well for the U.S. trade balance. American manufacturers who compete against European companies will likely enjoy the most success this year in increasing market share. Japanese companies, meanwhile, may limit price increases well below the rise in the yen in order to retain strong market positions.

Summary

The economy grew at a respectable 3.2% annual rate in the first quarter of 1986. But much of the growth came from an inventory buildup that could reflect sagging sales. Retail sales in general dipped in both February and March, and auto sales in particular fell substantially in March. Meanwhile, industrial production also declined in both February and March.

One problem is that the positive effects from falling oil prices take longer to work through the economy than do the negative effects on oil-patch capital investment and employment. Another problem is that consumers, while buoyed by falling oil prices and interest rates, are also carrying a tremendous amount of debt. Moves to reduce this debt will crimp consumer spending. Business investment, meanwhile, will be sluggish due to oil industry cutbacks as well as by last year's softness in sales and profits.

The big winner in the current economy is housing. With falling mortgage rates making houses more affordable than at any time since 1979, construction starts are soaring. And with further declines in interest rates likely, housing should stay strong through this year.

Foreign trade will also be benefiting this year on the strength of the declining dollar. Because of delays in market adjustments to new currency relationships, however, the U.S. has been racking up record merchandise trade deficits. Later this year, these deficits should decline.

All told, the economy this year is expected to grow by a sluggish 2.4% . It won't be until 1987 that lower interest rates, oil prices, and the dollar really kick in to boost economic growth back above 3%.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

	1986				1987				Years		
	I	II	III	IV	I	II	III		85	86	87
National Product Accounts											
Gross National Product.....	4,117	4,148	4,209	4,251	4,323	4,399	4,477		3,989	4,181	4,439
Consumer Spending.....	2,671	2,694	2,740	2,773	2,815	2,862	2,913		2,582	2,719	2,888
Durables.....	362	374	384	387	392	402	409		361	377	404
Nondurables.....	939	919	936	946	955	963	979		912	935	972
Services.....	1,369	1,401	1,420	1,441	1,468	1,498	1,526		1,309	1,408	1,512
Nonresidential Fixed Investment.....	480	484	486	490	488	495	506		476	485	502
Structures.....	174	174	172	171	169	171	172		170	173	172
Equipment.....	305	310	314	319	319	325	334		306	312	330
Inventory Change.....	30	14	10	7	14	19	23		7	15	20
Residential Investment.....	194	203	212	215	218	218	217		181	206	218
Federal Government.....	354	350	354	349	355	358	364		355	352	361
Defense.....	267	258	262	265	271	274	279		262	263	277
Nondefense.....	88	91	92	84	84	84	85		94	89	85
State & Local Government.....	479	486	493	500	506	513	520		460	489	517
Net Exports.....	-95	-87	-92	-88	-77	-72	-71		-78	-91	-72
Real GNP (1982 Dollars).....	3,619	3,643	3,675	3,693	3,728	3,770	3,805		3,570	3,657	3,785
(% change, annual rate).....	3.2	2.6	3.6	2.0	3.9	4.6	3.7		2.2	2.4	3.5
Implicit Price Deflator.....	1.137	1.139	1.145	1.151	1.160	1.167	1.177		1.117	1.143	1.173
(% change, annual rate).....	2.5	0.6	2.4	2.0	3.0	2.6	3.4		3.3	2.3	2.6
Key Economic Indicators											
Housing Starts (million units)...	1.993	1.957	2.029	2.036	1.960	1.907	1.859		1.741	2.004	1.884
Retail Auto Sales (million units)	10.7	10.8	11.0	10.9	11.0	11.3	11.4		11.1	10.9	11.3
Industrial Production											
(Index, 1977=100).....	125.8	124.9	125.2	126.1	128.0	130.5	132.3		124.5	125.5	131.2
Civilian Unemployment Rate.....	7.1	7.0	6.9	6.8	6.7	6.6	6.5		7.2	6.9	6.5
Consumer Price Index											
(% Change, Annual Rate).....	1.4	-3.2	4.8	3.3	2.7	2.4	5.1		3.5	1.9	3.0
Personal Income (billion \$).....	3,398	3,437	3,482	3,523	3,570	3,629	3,691		3,293	3,460	3,661
3-Month Treasury Bill Rate (%)...	6.9	6.0	5.9	6.1	6.2	6.3	6.5		7.5	6.2	6.4
Corporate Bond Yield (%).....	9.6	8.8	9.1	9.1	9.1	9.1	9.2		11.4	9.2	9.1
Personal Income											
(\$ Billions, SAAR).....	3,398	3,437	3,482	3,523	3,570	3,629	3,691		3,293	3,460	3,661